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The Federal Insurance Office Releases Its Report On Modernization Of Insurance Regulation

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On December 12, 2013, the Federal Insurance Office (FIO), created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, released its long-overdue report on "How to Modernize and Improve the System of Insurance Regulation in the United States".[1] The Report promotes uniformity among state insurance regulators and supports federal action to support state efforts, particularly in the areas in which Congress has provided the FIO or other federal regulators authority to act. In limited instances, however, the FIO appears ready to recommend significant federal intervention, which could supplant state regulation.

The Report is divided into five sections, as follows:

(1) Recommendations for modernizing U.S. insurance regulation;
(2) History of U.S. insurance regulation;
(3) Analysis to support the recommendations regarding prudential oversight issues;
(4) Analysis underlying the recommendations concerning marketplace oversight with a focus on the need for national uniformity; and
(5) Insurance modernization in the context of basic principles of regulatory reform.

A brief overview of the significant findings and recommendations which may impact the ever-shifting insurance regulatory landscape is set forth below.

1 Dodd-Frank mandated the drafting and public release of the high-level Report on regulatory modernization by January 2012. 31 U.S.C. § 313(p).

Prevailing Approach Toward U.S. Insurance Regulation

A significant portion of the Report addresses the role of the federal government in regulating insurance in the aftermath of the 2008 financial crisis. While acknowledging the long-standing history of state-based insurance regulation, the Report gives credence to the notion of a significantly expanded role for the federal government in regulating the insurance industry. The Report acknowledges two distinct approaches to possible expanded federal involvement in insurance regulation: first, an approach which posits the federal government as a consensus-builder among the states to develop uniform regulatory standards to be enforced by the states; and second, an approach premised upon federal preemption and replacement of state regulation with federal rulemaking and enforcement authority.

For the most part, the Report advocates the first approach and proposes a federal role in developing uniform regulatory standards among the states in order to reduce the burdens created by more than 50 different state regulatory schemes. The Report notes that a U.S. insurer pays 6.8 times more to comply with the state-based regulatory scheme than a similar U.K.-based insurer. The Report primarily recommends federal intervention in those areas "in which that involvement would solve problems resulting from the legal and practical limitations of regulation by states, such as the need for uniformity or the need for a federal voice in U.S. interactions with international authorities."

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The FIO recognizes that there are instances where national interests demand that a single regulator exercise control over a particular aspect of the business, for example, mortgage and financial guaranty insurance. Given that the relationship of this business to the 2008 financial crisis, the FIO is of the position that these systemically vital lines of insurance should be governed by federal rules promulgated by a federal agency. Whether Congress will pass sweeping new regulatory legislation that more deeply entrenches the federal government in the housing and financial markets, however, is uncertain.

"Prudential Oversight" Recommendations

Proposed Uniformity in Solvency Regulation

Unlike banks, insurers are not subject to standardized international capital requirements, and are instead subject to state-specific risk-based capital (RBC) requirements derived from the National Association of Insurance Commissioners' (NAIC) Financial Regulation Standards Accreditation Program (Program). While state-specific RBC requirements currently take into account an insurer's specific investment, underwriting, interest rate sensitivity and business risks in formulation of an insurer's capital requirements, there is significant variation among state regulators in the implementation of such requirements. At present, an insurer's domestic regulator is the sole arbiter of an insurer's capital requirements, and that regulator maintains wide discretion in formulating RBC requirements.

The FIO's Report recommends that capital requirements for insurers be imposed in a more uniform fashion by: (1) requiring any insurer's domestic state regulator to obtain the approval of all other state regulators in jurisdictions in which that insurer operates and to consent to any deviation from the NAIC's Program for determining RBC requirements; and (2) subjecting the NAIC's Program to an independent, third-party audit. The FIO further asserts that as states begin to implement practices and procedures for insurers to conduct Own Risk Solvency Assessments (ORSA), the states, presumably through the NAIC, must work together to implement "best practices, standards and principles" that are developed through international consensus. Notably, the Report omits any discussion of the nature of such ORSA best practices, and openly questions whether state regulators may have the resources and/or the technical skills to effectively review insurers' self-assessment of risk.

Credit for Reinsurance

As the international reinsurance market continues to expand and impact the U.S. marketplace, enhanced concerns have been expressed regarding stringent and inconsistent state-specific regulation of the accounting treatment of risk ceded by domestic insurers. Presently, domestic insurers are not permitted to reduce their liability reserves in relation to the amount of risk ceded to overseas reinsurers without the reinsurer in question posting large amounts of collateral to guaranty its reinsurance obligations. Various state permutations of the NAIC Model Collateral Law allow overseas reinsurers to reduce their collateral posting obligations if they are deemed credit-worthy by the specific state regulator. The Report highlights the impact of inconsistent state regulation upon the U.S.'s participation in international insurance markets.

To remedy the inconsistent accounting treatment of liabilities reinsured internationally, the Report recommends that the FIO and the United States Trade Representative (USTR) exercise the powers granted to them under Dodd-Frank to enter into international covered agreements regarding reinsurance collateral requirements. These covered agreements would preempt applicable state law and create a uniform system for the accounting of reinsured liabilities. If the FIO and USTR follow this recommendation, the NAIC's Model Collateral Law would become moot.

Proposals on Captive Transparency

The FIO's Report suggests reform of captive reinsurance arrangements, particularly in the context of life insurance. The Report questions the current system of captive regulation, describing captive reinsurance arrangements as "mechanisms by which insurers decrease capital and reserves at the insurance entity level . . . while also reducing overall regulatory scrutiny across the group." The FIO asserts that captives allow the insurer to reduce its reserve and capital requirements through risk transfers to less-regulated entities. The FIO also notes the perceived lack of interstate transparency on captive regulation because only the captive's domestic regulator has access to financial statements. The Report calls upon the states to develop both a uniform standard of robust financial transparency and a system of public financial disclosures for captive insurers domiciled anywhere in the U.S.

Group Supervision and Corporate Governance

The FIO's Report is critical of the current state law addressing corporate governance underlying both individual insurance companies and their group holding company systems. The Report notes that no NAIC model laws or regulation directly regulate individual company corporate governance. The FIO recommends that state regulators develop and adopt director and officer qualification standards "that require individuals serving in those roles to have the expertise to assess strategies for growth and risks to the enterprise." Notably, the FIO does not recommend any federal involvement in the development of such standards, and qualifies its recommendation by stating that standards should be "appropriately scaled to the size and complexity of the firm."

Holding company system regulation is of even greater concern to the FIO. The Report describes the current NAIC Model Holding Company Act as granting only "indirect" supervisory authority to state regulators over non-mutual holding companies which control individual insurers. The Report refers to recent International Monetary Fund recommendations that the U.S. transition its "solo-entity" regulatory system to a system focused on regulating the group of companies of which an insurer is a part. The Report stops short of recommending federal action in this regard, however, and instead suggests that the states, in conjunction with the NAIC, address this perceived shortcoming and develop so-called "supervisory colleges" among all regulators with jurisdiction over a particular group of companies. The supervisory colleges are intended to encourage regulatory collaboration among applicable regulators.

Post-Insolvency Regulatory Recommendations

The FIO makes several recommendations aimed at promoting uniformity among state insurer insolvencies laws, and specifically recommends the adoption of a uniform approach to the termination of derivative investments and other qualified financial contracts (QFCs) upon the insolvency of an insurer. While federal bankruptcy law and most international regulatory schemes allow QFCs to be terminated and closed on a net basis upon the insolvency of a counterparty (despite any automatic stay), several state insurance insolvency laws do not so provide. The FIO Report alleges that the failure of the states

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to uniformly adopt an analogous provision to the bankruptcy code makes access to the derivatives markets much more expensive for insurers, and adversely affects global derivatives markets by keeping many insurers' capital on the sidelines. The Report also recommends that states, in conjunction with the NAIC, develop consistent and transparent financial reporting methodologies to be used by the receivers of insolvent insurers.

Notably, the FIO acknowledges the critical role that insurance guaranty funds play in protecting financial systemic stability in the event of an insurer insolvency. While the Report recognizes the "significant apparent capacity" of guaranty funds to handle an insurer insolvency, the Report nonetheless expresses mild trepidation regarding the ability of the various state funds to effectively handle the demise of a large, U.S. insurance group, and notes that an event leading to one insurer's financial demise may impact other insurers, as well. The Report recommends that the National Conference of Insurance Guaranty Funds (NCIGF) and National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) periodically monitor the impact of such an insolvency upon the guaranty fund system and conduct appropriate stress testing under adverse scenarios. The Report also notes the disparate coverage limits afforded to a policyholder by guaranty associations in various states. Highlighting the discrepancy between the $500,000 in protection afforded to a New Jersey annuitant under New Jersey's statute and the $100,000 in protection granted to an Indiana annuitant of the same insurer by the Indiana Fund, the FIO states that federal intervention to create uniform guaranty fund benefits and recovery rules may be necessary if states cannot achieve uniformity on their own.

Marketplace Oversight and Consumer Protection Recommendations

Producer Licensing Reforms

Despite widespread adoption of the Producer Licensing Model Act (PLMA) and the formation of the National Insurance Producer Registry (NIPR), the FIO notes with disapproval that each state imposes unique requirements on individuals and entities seeking producer licensure. The Report, therefore, calls on Congress to pass the National Association of Registered Agents and Brokers proposal (NARAB II), which is presently before the Senate (and previously passed by the House). The NARAB II proposal would create NARAB, which would function as a multi-state producer licensing body. If successfully implemented, NARAB could further reduce the effort and expense of multi-state licensing.

Product Approval

The Report calls upon all state regulators, including New York, California, and Florida, to join the Interstate Insurance Product Regulation Commission (IIPRC), an organization formed through adoption of NAIC model law streamlining review of new insurance products across all member state insurance regulatory bodies. The FIO believes that state-specific review of all new insurance products creates significant inefficiency and lack of uniformity. If hold-out states were to join the IIPRC, the FIO would view this as a critical first step toward reducing unnecessary and duplicative regulatory burdens on insurers. The Report further recommends that the IIPRC add processes for the review of life, annuity, long-term care and disability products, currently excluded from the purview of the IIPRC. Finally, the FIO recommends a continuation of the current "modernization" trend toward commercial lines deregulation. The Report provides that a failure to implement commercial lines deregulation ultimately will direct insureds to the less regulated surplus lines marketplace.

Market Conduct Examinations

The Report calls for state regulators to increase communication and coordination in order to reduce unnecessary burdens on insurers responding to multiple states' investigations and examinations. The Report makes few concrete suggestions as to how state regulators should implement the FIO's proposed reforms. States are encouraged to formulate accreditation standards and protocols for private contractors engaged by them to conduct examinations in order to improve the quality of their work. The Report does not suggest, however, that the FIO will seek increased federal involvement in the market conduct examination process if state regulators fail to implement the suggested reforms.

Variable Product Sales

The Report criticizes state-specific regulation of the sales of variable annuities by life insurers to retirement age purchasers, as opposed to the nationally applicable FINRA rules governing sales practices and suitability requirements. The Report articulates the FIO's support for uniform state adoption of the NAIC's Model Suitability Regulation in order to standardize the sales practices of licensed annuity producers across the country. Unlike other recommendations for uniform state adoption of NAIC model laws, however, this recommendation is supported by proposed federal involvement. The Report strongly recommends that the Consumer Financial Protection Bureau (CFPB), empowered under Dodd-Frank to grant financial incentives directly to states which adopt the NAIC Model Suitability Regulation, take steps to do so.

Risk Classification in Personal Lines Insurance

The Report recognizes opposing views as to the extent to which insurers should be permitted to consider controversial underwriting factors such as credit score and the demographics underlying the prospective insured's property. The Report, however, sides squarely in favor of prohibiting any impermissible discrimination, even at the expense of more accurate risk pricing, in order to ensure that personal lines underwriting practices do not impede upon federally protected civil rights. The FIO supports promulgation of federal standards regarding permissible risk classification factors, in particular to prohibit discrimination against the LGBT communities in states where same-sex marriage is not permitted, but marriage is a factor supporting lower personal lines insurance premiums. The FIO also calls for state regulation of third party providers of personal information to insurers (credit reporting bureaus) to remedy personal privacy concerns.

Implementation of the NRRA

The Report characterizes the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA) as a model of multi-state cooperation and streamlined insurance regulation, but criticizes the states for failing to implement the law effectively. The NRRA, effective in July 2011, prohibits any state other than the "home state" of an insured from charging premium tax on surplus lines insurance. The Report identifies the recent failures of multi-state compacts aimed at streamlining premium tax collection while still allocating surplus lines premium tax revenue to the various states. Many states apparently have simply elected to retain all premium tax revenue collected on surplus lines insurance placed on a multi-state basis where the State is the insured's "home state." The FIO voices its preference for a multi-state compact to

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be implemented. If states do not make significant progress toward cooperation in the sharing of surplus lines insurance premium tax revenue, the FIO will likely recommend further federal action to remedy the situation.

Forecast For The Future

It is unclear whether enhanced regulatory authority will be delegated by Congress to the FIO in the near future – which likely will hamper the implementation of many of the FIO's strongest recommendations. In the near term, this leaves the FIO in the position of supporting the existing state system of regulation by encouraging or even incentivizing existing efforts of the NAIC to obtain widespread adoption of model laws and regulations.

Congress has taken action in response to other statutorily-mandated assessment reports, and such action has eventually led to significant regulatory legislation and/or rulemaking. For example, the 1940 Investment Advisors Act is widely considered to be derived from a major report commissioned by Congress in 1935 and released by SEC staff in 1939. More recently, Dodd-Frank ordered the Financial Stability Oversight Council (FSOC) to formulate a report on many of the proprietary trading practices of banks. The FSOC's recommendations now form the backbone of the Volcker Rule recently released and currently being implemented by financial institutions.

Public outcry for financial reform in the wake of the 2008 crisis, even if such reform is not directly related to the root causes of the crisis, means insurers and other institutions subject to the FIO's wide sphere of influence should cautiously anticipate the implementation of the Report's recommendations. ■

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